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## The economic and financial crisis in Europe: addressing the causes and the repercussions

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### Introduction<sup>1</sup>

The European economy has been hit hard by the global economic and financial crisis. Commentators have been reaching for the superlatives to describe the extent of the impact and the threat to economic well-being: the most frequent comparison is with 1929 and the Great Depression that followed. Others, though, have pointed the finger at single actors – central banks and their ‘easy money’ policies, greedy Wall Street titans, sleepy regulators – implying that, once such incompetents have been removed, we can return to business as usual. Still others cling to a medieval-style fatalism in which crises are a divine and inevitable penalty for ineradicable human sins.

This article looks at the extent of the challenge facing European policymakers as a result of the crisis. It provides an analysis of the current economic situation, looks at the forces that have driven the European economy off what had until recently been a quite decent and seemingly sustainable growth trajectory, and considers how deep and protracted the downturn is likely to be. From this it concludes that, unlike the United States, where a prolonged and serious downturn is inevitable, the European economy *could* be steered relatively swiftly out of the mess, provided decisive policy action is

taken. The article then proposes a set of five essential steps that need to be taken in the short term at European and national level to arrest the downturn, and points out areas requiring substantial ‘structural reforms’ in the medium term. Given the serious question-marks as to whether European policymakers will do the right thing, one can be no more than *conditionally* optimistic about the medium-term prospects. A 1929-scenario is far from inevitable, but it remains a possibility.

### The current situation and immediate outlook

Having recovered painfully slowly from the downturn initiated by the collapse of the Internet bubble, the European economy had performed strongly in 2006 and around trend in 2007. The first audible rumblings of the crisis in the summer of 2007 did not immediately affect quarterly growth rates; initially it seemed that Europe might manage to ‘decouple’ from the US.

However, following unexpectedly strong first-quarter figures in 2008 (flattered by a mild winter), economic growth plunged. Following a quarter-on-quarter contraction of 0.2% in the second quarter in the euro area (0.0% in EU27), the first estimate for the third quarter is for a contraction of 0.2% (in both the euro area and EU27).

This course of events has been accompanied by equally swift downward revisions of forecasts for 2009 (**Table 1**). From earlier predictions of around 1.5%, below-trend, but far from a crisis, all the major international institutions now foresee a contraction in economic output in Europe in 2009, and have emphasised the downward risks to their forecast. Just a month after its major autumn forecast in October, the IMF rushed out an update (end November) in which the GDP forecast was cut by 0.7 percentage points (p.p.).

<sup>1</sup> I have benefited from discussions with numerous colleagues on the economic crisis. I am particularly grateful to Peter Coldrick, Frank Hoffer, Bela Galgoczi, Vera Glassner, Volker Hallwirth, Maria Jepsen, Heike Joeßges, Karl Pichelmann and Philippe Pochet for comments on a previous draft. The usual disclaimer applies.

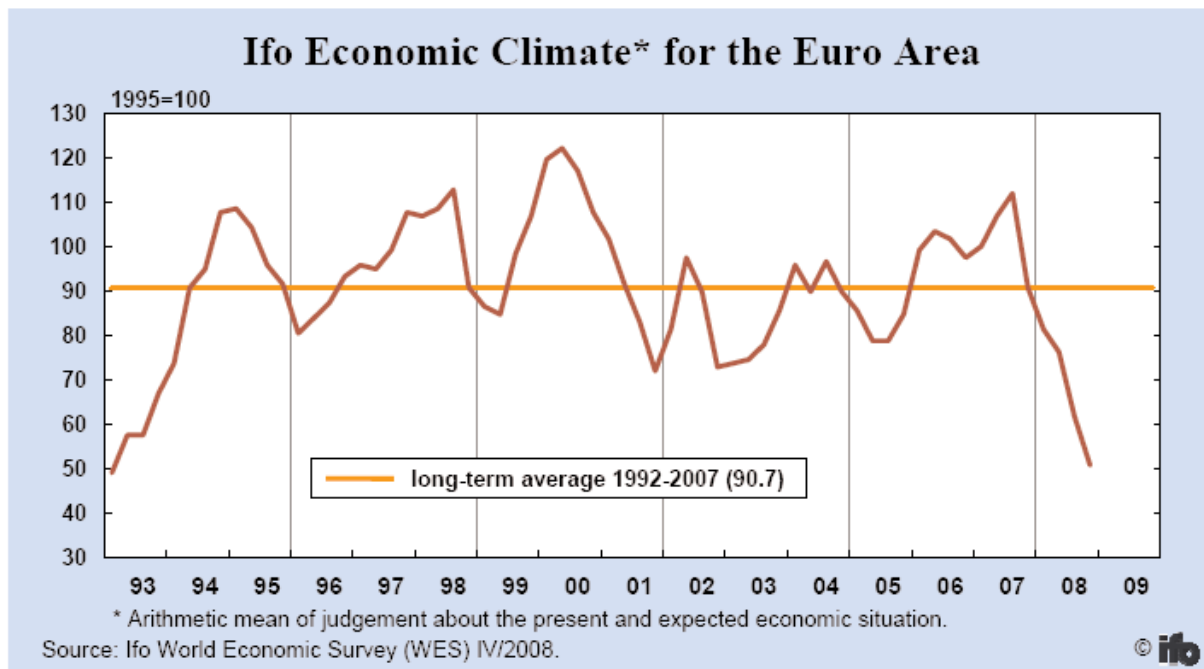
In the course of November a whole slew of negative data came in<sup>2</sup>. Most worryingly, unemployment, an indicator that lags the business cycle, is creeping up, to 7.7% and

7.1% in the euro area and EU27 (from lows of 7.2% and 6.7%). Almost a quarter of a million jobs were lost in the euro area in October alone.

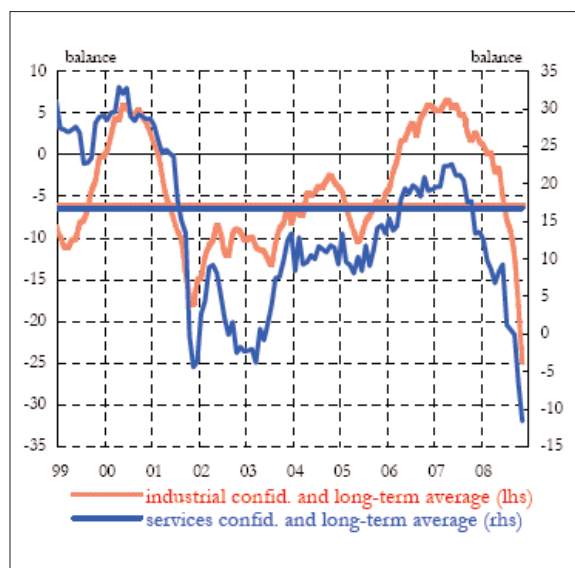
**Table 1: Economic forecasts for 2009, euro area (EU27)**

<b>IMF</b>	-0.5% (Nov. 6)	0.2% (Oct.)	1.2% (Apr.)
<b>European Commission</b>	0.1% (0.2%) (Early Nov.)	1.5% (1.8%) (Spring)	
<b>OECD</b>	-0.6 (Late Nov.)	1.4% (Spring)	

<sup>2</sup> Volume of retail trade down 0.8% in the euro area and 0.3% in EU27 (October on previous month); industrial production -1.6% in the euro area and -1.1% in EU27; and incoming industrial orders: -3.9% in euro area and -4.6% in EU27 (both September on previous month).

**Figure 1a, 1b: Ifo and EC confidence indicators: collapse in confidence**

Source: Ifo Institute



Source: European Commission

Worse is clearly to come. Forward-looking indicators have fallen precipitously (**Fig. 1**). The European Commission's confidence indicators for the euro area have plummeted to depths not seen since the start of monetary union, while the ifo Institute's euro area survey is now at levels equivalent to the recession of the early 1990s, and has yet to bottom out. The immediate cause of this collapse in business confidence is not hard to make out. European firms are being squeezed from both sides. At the same time as both domestic and export demand weakens and uncertainties grow about sales prospects, firms face a severe increase in the cost of and/or the difficulty of access to the finance they need for investment and, in some cases, merely to replenish working capital.

Figure 2

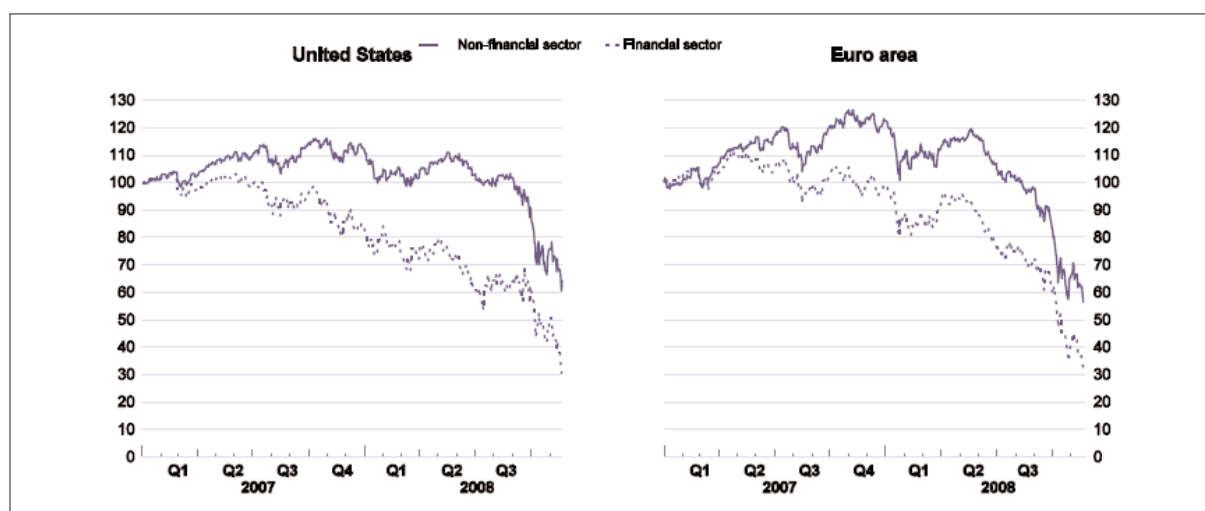


Figure 3

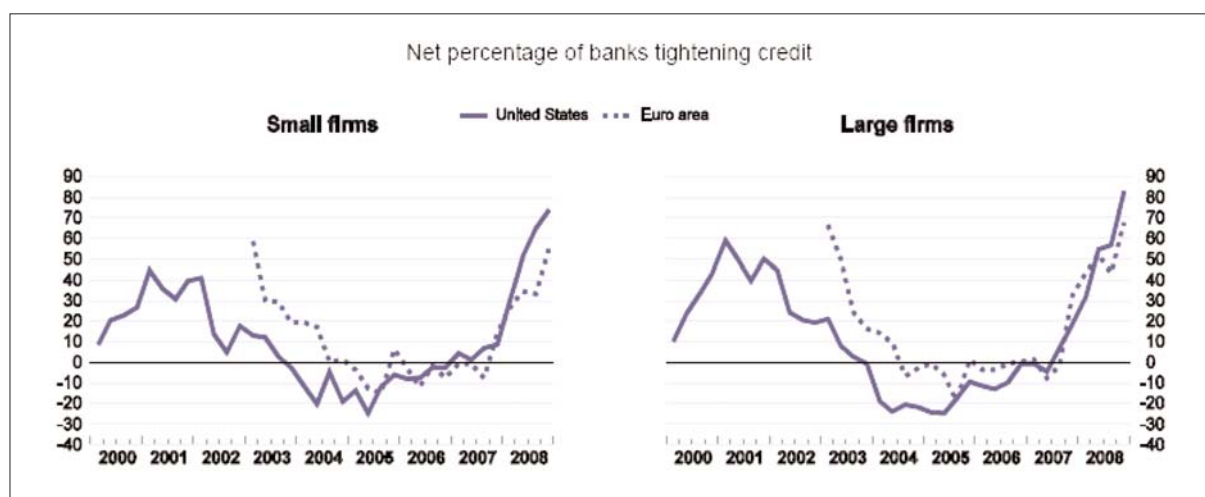
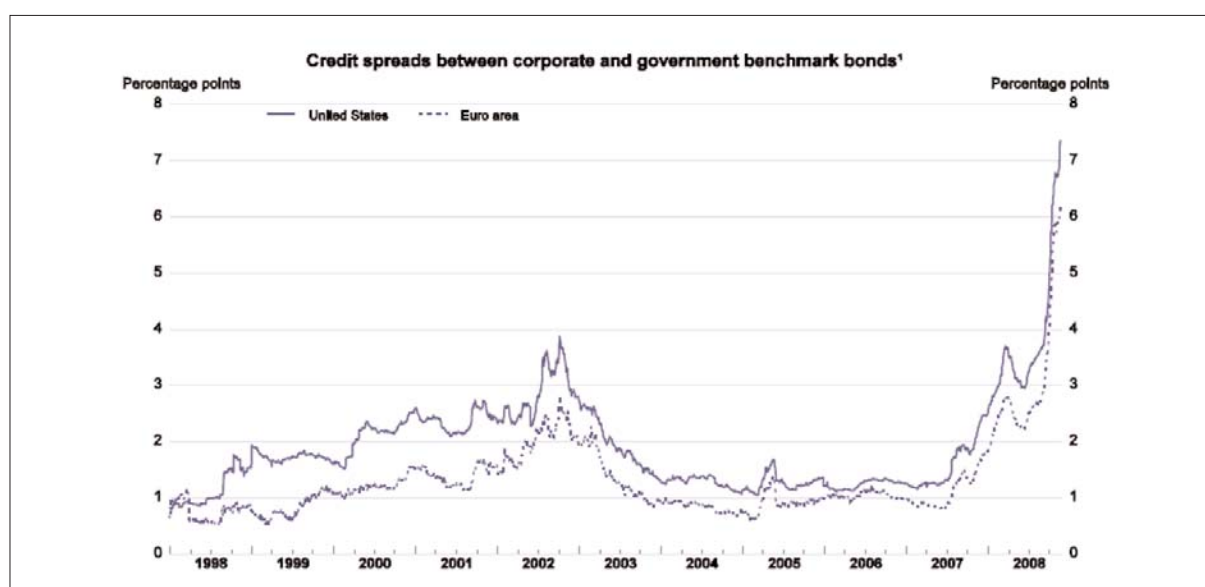


Figure 4



Source: OECD Economic Outlook, 84, Nov. 2008

**Figs. 2, 3 and 4** provide a succinct illustration of the three main dimensions of the financial squeeze on firms. Firstly, stock markets in the euro area have plunged almost exactly in parallel to those in the US. Even non-financial listed companies have lost about 40% of their book value; for financials the hit amounts to around 60%. This makes it difficult for firms to raise equity capital and – for financially viable firms – also reduces the incentive to invest in new capacity.<sup>3</sup>

Secondly, OECD composite measures of bank lending indicate that banks are massively restricting their lending to firms, either in the form of increased costs or other restrictions, such as demanding higher levels of collateral (although rather less in the euro area than in the US). This of course is a knock-on effect of the wave of pervasive uncertainty that has hit the banking system, and the real or perceived need of banks to repair their balance sheets and retain capital.

Thirdly, the spread between the interest rate on corporate bonds and those on benchmark government securities, in normal times between 1 and 2 p.p., has shot up to as much as 6.p.p.; again this is topped by the US. Firms with slightly lower credit-ratings, in particular, are now paying a very much higher premium on new bond issues. Even if the impact is partly offset by a decline in the benchmark rate (reflecting the economic recession and lower central bank rates), this implies a huge increase in the costs to (large) firms of obtaining finance on corporate debt markets.

All these indicators point to a bleak short-run outlook for the European economy. Overseas

demand has fallen sharply. Consumers and especially firms are retrenching. Business confidence is shattered. Banks are reluctant to lend to each other – as evinced by still high spreads of inter-bank rates over short-term policy rates – and to non-financial businesses and households. Under such conditions the economic contraction is bound to continue over the coming quarters. Before we can assess how long and how deep the recession will be, we need to consider the developments that have led to the crisis.

### **How did we get here?**

The causes of the crisis have been much discussed and are clearly complex. Much as in a war, the definitive account, if it is ever written, will probably have to wait for the ‘fog of crisis’ to lift. What is undisputed is that the centre of the storm was in the USA from where it moved directly to Europe and also indirectly via emerging markets. Behind this development lay a whole series of imbalances at different levels and in different spheres that interacted with developments in the way advanced capitalist economies have been operating, particularly but not exclusively in their financial sectors. This section looks at some of these fundamental drivers behind the crisis, focusing on seven key developments, and provides a provisional interpretation of some of the causal linkages between them. It will be necessarily schematic and the trends identified will apply with greater force in some countries than others. Further analysis will be required to tease out the interactions between these trends more precisely. It then shows how these trends served to accelerate a downturn in economic activity in Europe that had more direct and also more familiar causes.

### **Fundamental causes of the crisis**

A prominent feature of global economic developments has been pronounced and per-

<sup>3</sup> Tobin’s Q, the ratio of stock valuations to the replacement cost of listed firms’ assets, has fallen and companies have less incentive to invest in new capacity rather than acquire existing firms’ assets via takeovers.



sistent current account imbalances. Most notably the USA (but also, in Europe, the UK and Spain) have run large current account deficits, offset by corresponding surpluses in, notably, China, Japan and Germany. Total domestic consumption and investment in the US has been persistently and substantially (of the order of 5-6% of GDP) above domestic output. The gap has been met by borrowing: surplus countries have piled up financial assets which have kept long-run interest rates in the US low (and thus helped sustain the imbalances). Surplus countries have sought to export their way out of unemployment (Germany, Japan) or into rapid industrialisation (China).<sup>4</sup> Increasingly dissatisfied with meagre returns on safe assets, such as Treasury bills, they (alongside domestic investors) have purchased more complex, opaque assets provided by Wall Street financial alchemists (to which we return) that offered higher rates of return. In Europe, Germany's persistent trade surpluses are one important fundamental reason why its banks held large amounts of what subsequently proved to be toxic financial products originated in the US.

A second feature has been the rapid internationalisation of production, investment and financial linkages – in short ‘globalisation’ – without a corresponding development of supervisory and other forms of regulation at an appropriate (global, European) level. Global institutions still reflect the geo-political realities of the post-Second World War period and, at best, their policies and activities reflect the needs of isolated (developing) countries requiring support. One consequence of this lack of appropriate institution-

al arrangements has been regulatory competition between jurisdictions in areas such as taxation, corporate law, financial sector regulation, etc. The lack of effective global governance allowed the problem of current account imbalances to fester.

Partly as a result of these shortcomings, but partly also in the wake of a major political shift in advanced capitalist economies since the early 1980s, we have seen, thirdly, a sustained and far-reaching process of state withdrawal from involvement in the economy. Amongst other things, state ownership (not least of financial institutions) has been reduced, labour market and welfare state institutions have been weakened, commercialised, or privatised, enforced (or at least enforceable) legal regulation has been dropped in favour of codes of conduct and so-called self-regulation. Legal and social constraints on the operation of businesses, and not least the influence of trade unions, have been massively reduced in favour of ‘right to manage’ and ‘shareholder value’ approaches. Key in the present context is that it is not the case that governments have simply failed to keep up with financial innovation. The financial services sector has been *actively de-regulated* at the explicit behest (and in the US, at least) with the help of substantial political donations of financial institutions that are now holding out their hand for state support. Ironically, many of the regulations repealed – such as the Glass Steagall Act in the US – had been introduced in the wake of the Great Depression.

These trends, perhaps enhanced by technological developments, have led, fourthly, to very substantial shifts in income distribution in most advanced capitalist countries. Almost all advanced capitalist countries have seen major shifts in the functional distribution of income (i.e. from labour to profits) and/or widening disparities in personal income (a wider gap between the rich and the

<sup>4</sup> Ironically Asian countries' desire to pile up foreign currency reserves was in large part a reaction to their experiences of capital flight during the Asian crisis of 1997ff.



poor, and especially a de-coupling of the incomes of the rich from those of the rest of society).<sup>5</sup> This has placed an increased share of resources in the hands of those who, rather than consume it in the form of real goods and services, have used it to speculate on financial markets. Meanwhile, at the other end of the income scale, the poor have been forced to expand borrowing in order to maintain living standards in the face of stagnating real wages in many countries.<sup>6</sup>

Still poorly understood is the way in which, fifthly, this has interacted with the ‘financialisation’ of the economy. This umbrella term covers diverse trends such as the increasing size of the financial sector, the expanding volume of financial transactions and products (relative to GDP), and changes in corporate governance towards ‘shareholder value’, the increased use of stock options and other forms of (short-term) incentive payments to senior managers, the growing role of Chief Financial Officers within large corporations, and changes in the structure and products of the financial industry itself. Without attempting a full analysis, a number of key points can be made.<sup>7</sup> The rising share

of profits in national income (in most countries) has not been accompanied by a rising investment share. The activities of corporate managers appear ever more driven by short-term concerns (specifically an obsession with current share prices), which may partly explain the sluggish investment (with respect to high profits). A concomitant of this is that much of the funds potentially available for ‘real’ investment instead flowed into either existing real assets (notably housing) or into financial claims of increasing complexity and opacity.

One aspect of financialisation has had such importance for the crisis that I will treat it separately (although it is intimately related to the trends just mentioned). It is, sixthly, securitisation – the rendering tradable of formerly untraded contractual relationships, such as mortgages and other loans, and thus the diffusion of risk exposure (e.g. Frank and Krahnen 2008). Technological improvements and competition between deregulated (and globalised) financial institutions led, against the background of increased demand for savings opportunities by institutional investors (flooded with the savings of retirees as a result of demographic processes and pension privatisation) and wealthy individuals, to a proliferation of increasingly complex financial products. For our purposes, a number of key features need to be mentioned. The selling-on of risk has led to misaligned incentives on the part of those originating the underlying contracts<sup>8</sup>, in particular to misrepresentation of the nature and extent of risk to ill-informed consumers; ownership of various securities (and of the attendant risks) has become virtually impossible to trace and thus to monitor; purchasers of such products have tended to put their faith in rating agencies which have a quasi-legally institutionalised oligopoly and are paid by product-issuers (and not purchasers), and/or have taken out ‘insurance’ in the form of credit default swaps (which are of dubious value

<sup>5</sup> The OECD has recently published a comprehensive study of income inequality trends over the last twenty years (OECD 2008).

<sup>6</sup> This latter trend has been exacerbated by developments such as cuts in public provision of health care, higher education finance, etc.

<sup>7</sup> Contributions that have begun to tease out some of the implications of ‘financialisation’ include: Hein and van Treeck (2008), Palley (2008a) For an analysis of the role of private equity within this complex see Watt (2008).

<sup>8</sup> It can be noted in passing that this is not the case provided one assumes ‘perfect information’. Of course precisely this abstruse assumption is a cornerstone, along with its close cousin, ‘rational expectations’, of mainstream economic theory.

and constitute an important remaining source of financial-market risk). The main result of this has been a vast increase in various measures of 'leverage': higher ratios of household debt to GDP, a shift in the balance between equity and debt finance in corporations, rising mortgage debt to housing equity ratios, etc.

It is only against this background that a seventh feature, to which many commentators have, in my view incorrectly, ascribed central importance in explaining the crisis, can and must be mentioned: a period of historically low real interest rates. It is true that low real interest rates increased the appetite for risk ('search for yield') and were a proximate cause of inflating asset prices and increased leverage. Yet the appropriate level of interest rates must be judged against the performance of the economy (the 'supply side'). Particularly in the case of Europe, which recovered painfully slowly from the 2001 downturn, it is hard to argue that interest rates were set too low. A more plausible argument can be made that modern central banking (and economic theory) has relied too heavily on interest-rate setting, and ignored other demand-management instruments (notably fiscal policy) and other central bank instruments (such as minimum reserve requirements and other supervisory and regulatory measures), so as to pursue aims such as financial stability without affecting the management of the real economy.

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<sup>9</sup> The much greater increases in the (usually cited) USD prices were offset to a considerable extent by currency appreciation. The oil price (in euros) has since returned to roughly the level at the start of 2007. The figures in this and the following two bullet points are taken from the European Commission's 'Key indicators for the euro area': [http://ec.europa.eu/economy\\_finance/publications/publication12486\\_en.pdf](http://ec.europa.eu/economy_finance/publications/publication12486_en.pdf)

While the causal chains discussed above are still imperfectly understood, it is clear in retrospect that this constellation of very diverse factors constituted a perfect storm of complex interacting forces. Any attempt to identify one single culprit or policy mistake behind the crisis is doomed to failure. On the other hand, these factors have been around for several years, in some cases decades. We must therefore now turn to the proximate causes of the 2008 downturn in Europe.

### **Proximate causes of the crisis**

The above structural features, and especially the role of the financial sector, have been much discussed (and frequently misinterpreted). Many observers have overlooked a series of quite traditional negative aggregate demand shocks that have hit the European economy in recent months, constituting the proximate causes of the slowdown. This risks leading to inadequate policy recommendations (such as focussing on medium-term re-regulation of the financial sector). The main contractionary impulses have been as follows:

- Sharp rise in commodity prices: oil prices more than doubled in euro terms from under EUR40 to around EUR90 between the start of 2007 and the summer of 2008<sup>9</sup>, similar spikes were recorded in a large number of other commodities: non-energy commodity prices were rising at year-on-year rates of around 10% during 2008. This raised firms' costs and depressed workers' real incomes, reducing aggregate demand, as inflation briefly spiked at around 4%.
- Sharp appreciation of the euro: the euro appreciated against the USD, still the leading global currency, from USD 1.20 to 1.60 – that is by a massive 33% – between the start of 2006 and the summer of 2008. There was a broadly parallel rise against the yen. The nominal effective

exchange rate of the euro rose around 15% by the summer of 2008 from its average in 2005. While partially offsetting the rise in world commodity prices, the strength of the euro squeezed firm's profit margins in the tradable goods sector and depressed net exports. As a result the EA15 trade and current account balances have moved from a slight surplus into deficit and export orders have plunged to a level not seen since the 1990s recession.

- Lagged effect of higher interest rates: the ECB began raising interest rates at the start of 2006. Eight rate hikes brought rates from 2.0% to 4.0% by mid-2007, against the background of rising headline inflation rates, largely driven by higher imported prices.<sup>10</sup> Through the usual transmission channels (including the currency appreciation already mentioned) and with the usual lags this has depressed aggregate demand.
- On top of these three major restrictive factors, which negatively affected all the European economies in a broadly similar way, (especially within the euro area), a number of individual countries faced specific problems. The UK, Ireland and Spain, in particular, shared a number of features of the US economy: housing bubbles, rising household debts and/or current account deficits or growing problems of international competitiveness. Such features were also characteristic of a number of the New Member States, exacerbated there by an increasing reliance on household debt denominated in non-

national currencies. From a European perspective, however, it should be emphasised that a needed cooling of some of these economies, by itself, should not have provoked a continent-wide slowdown as some other countries, and especially Germany, were simultaneously starting to grow at a faster rate and, at last, seeing faster wage growth, thus helping to re-balance the intra-European economy.

### **The interaction of home-made and external factors: from slowdown to crisis**

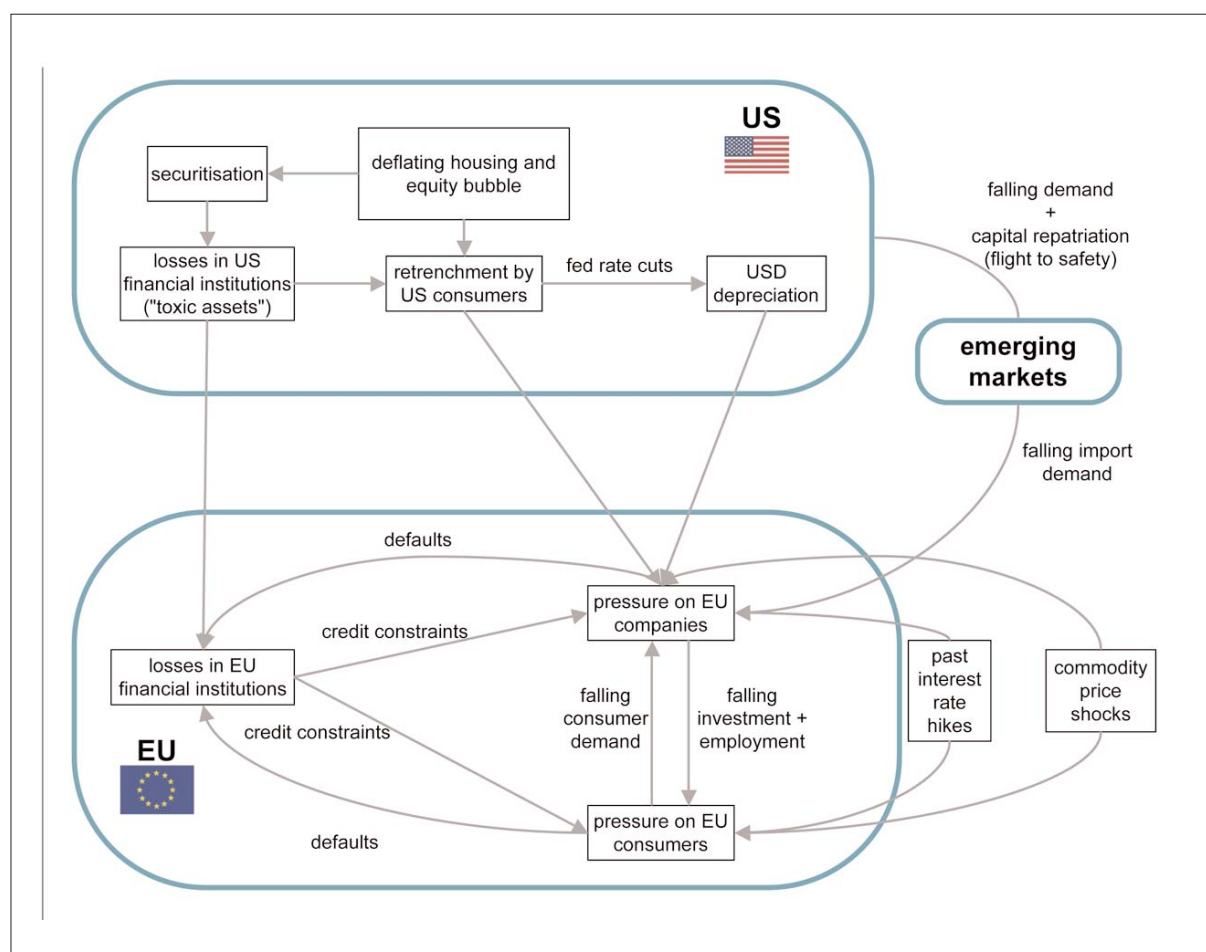
The dramatic downturn in the US, the unwinding of the financial and housing bubbles, the freezing up of credit markets, etc., which began in the summer of 2007, but accelerated dramatically in the autumn of this year, were saddled on top of these factors, which had already been eating away at the dynamic of economic activity in Europe. A schematic illustration of how the contagion from across the Atlantic and the underlying imbalances (discussed in 3.1) accelerated the impact of the largely internal (except commodity prices) restrictive forces (discussed in 3.2) in recent months is given in **Figure 5**.

The crisis was initiated by the deflating of the US housing bubble (and later the equity bubble), which set off a vicious chain reaction, with a number of negative feedback mechanisms.<sup>11</sup> This had a direct effect on consumer demand as rising house prices had been the cash cow of stretched US consumers (equity withdrawal, mortgage refinancing). Defaults and foreclosures increased. Worse, the securitisation of the underlying assets swiftly led to the implosion of the US financial sector, as losses emerged and confidence in the solvency of counterparties evaporated. The resulting credit crunch then impacted consumers and non-financial businesses that could no longer roll over loans, causing consumers to retrench and firms to lay off workers.

<sup>10</sup> It is important to note, however, that despite the massive imported price shocks, core inflation remained anchored at around 2.5% during the year.

<sup>11</sup> This is an extremely condensed account, as our interest is on the impact on Europe. For more detailed accounts on the unfolding of the US crisis see Baker (2009).

Figure 5



Source: Author's conceptualisation

There were (and continue to be) four main transmission mechanisms across the Atlantic.

- US consumer retrenchment (and also stalling business investment) directly affected the sales opportunities of European exporters, already squeezed by past currency appreciation.
- The European financial sector had been a major purchaser of 'toxic' assets from US banks. Their collapse in value or the

cessation of trading in these assets led to a knock-on implosion of the European banking sector, which then hit European companies (and to a lesser extent consumers, especially homeowners).

- The massive rate cuts by the US Federal Reserve in response to the crisis (initially unmatched in Europe) led to a sharp further fall in the USD against the euro, exacerbating the competitive pressure on European producers.
- Finally, and after a lag, the crisis also hit emerging economies (not least, China, where recent reports suggest a major increase in unemployment is likely<sup>12</sup>), which led them to cut their import demand.

<sup>12</sup> cf. 'Beijing forecasts grim employment outlook', *Financial Times*, 21 November 2008: <http://www.ft.com/cms/s/0/6fb1207c-b774-11dd-8e01-0000779fd18c.html>



Within European economies, this then set in train a standard negative interaction between the corporate and the household sectors typical of any recession. Firms cut investment and reduce working hours and staffing levels. Households – facing increased uncertainty, wealth-reducing asset price declines and tougher credit constraints – save more and some of them suffer income losses; overall consumption falls, worsening the situation of companies, which intensify job losses, etc. On top of this come negative feedback loops between the banking system and the household and non-financial corporate sectors.

Before turning to discuss issues of economic policy, it will be useful to sum up three key findings of the preceding analysis, which are decisive for the assessment of the crisis and what can and must be done about it. They are also important in that they are rather at odds with widely held views on the nature of the crisis.

The first is that the roots of the crisis are global, wide-ranging and highly complex, as are, of course, the intricacies of the highly developed financial systems that have served to accelerate the crisis.

But secondly, and perhaps seemingly paradoxically, the impact on the European economy and the causal chains now in play are rather simple, not at all new and well understood. Europe faces a severe negative demand shock coupled with problems in its banking and financial sector that, while the details may have changed, are highly reminiscent of previous banking crises, notably those in several Nordic countries in the early 1990s.

Thirdly, the European Union as a whole – this is not true of all its members individually – was clearly not overheating and did not suffer many of the major economic imbalances that so characterised the United States economy and to which the crisis is – in part – a necessary response. As has happened before (for instance in 2001), a downturn/crisis has been ‘imported’ from the US at a point in time at which, in terms of the supply side of the European economy itself, further sustained growth and, notably, reductions in unemployment would have been possible.

### **The policy response so far**

Before setting out a policy action plan, drawing on the insights gained above, to address the crisis, it will be useful very briefly to sum up what has occurred already at the level of the European institutions and key developments at Member State level.

Monetary authorities began already from the summer of 2007 to implement various measures aimed at improving the liquidity position of financial institutions. When inter-bank lending dried up following the collapse of Lehman Brothers in September of this year, central banks massively expanded liquidity provision to the banking system, easing requirements on collateral for refinancing operations. The ECB is generally regarded as having acted swiftly and effectively in this regard, not least in comparison with the Bank of England, where objections to ‘bailing out’ banks were part of the reason for the Northern Rock debacle (e.g. Buiter 2007).

The story is very different regarding monetary policy support for the real economy through interest rate cuts, however. In the teeth of what was, even before the Lehman collapse, quite evidently a very serious financial and economic crisis, the ECB kept up a hawkish rhetoric, rejected calls for interest-rate cuts<sup>13</sup>, and in July it actually

<sup>13</sup> In the spring already the European Labour Network for Economic Policy had called for 50bp of interest rate cuts during the summer (ELNEP 2008).

raised interest rates. This step was justified with respect to above-target inflation and the supposed danger of inflationary wage-setting. This paradoxical strategy of frantic support for the financial sector and restriction on the real economy could not be maintained long. In October the Bank was forced into an embarrassing reversal, cutting rates (in a coordinated action with other major central banks). This was followed by further cuts in November and December. However, while substantial compared with the 25 basis point (b.p.) adjustment typical of normal times, they were dwarfed by the cuts in the US and the UK. Overall, bank rates in these countries have been cut by 425 and 300 b.p., compared with just 175 b.p. in the euro area. Even if the crisis has hit the US and UK harder than the euro area, the ECB is seriously behind the curve in its demand-management reaction to the crisis.

The activities of national governments in response to the crisis can, from a European perspective, be characterised as an initial phase of 'sauve qui peut', followed by some limited coordination of crisis management. Initially governments scrambled to prevent their national financial sectors from unravelling. This quickly led to problems, however. Public support for deposit insurance with domestic banks, for instance, led to destabilising shifts in savings as panicky European savers sought to place funds where they seemed safest. More fundamentally, the

whole concept of a 'national' financial sector had been rendered moot by the Europeanisation of financial institutions. This led to serious rows between European governments concerning the details of bail-outs and depositor protection. Particularly problematic was that some countries that had, effectively, poached banking business, by offering low-regulation and low-tax regimes, then benefited from other countries' rescue packages which covered subsidiaries of domestic financial institutes registered in these countries. At the same time, some European governments pragmatically joined forces to save cross-border institutions (such as the Benelux countries and France in the cases of Dexia and Fortis).

The European Commission issued a Communication in October of this year that was totally inadequate in its analysis and short on concrete proposals (European Commission 2008a).<sup>14</sup> At the end of November, though, the Commission announced a European Economic Recovery Plan which recognised the urgent need to support aggregate demand and made a number of sensible proposals (European Commission 2008b).<sup>15</sup> Specifically, it called for an immediate budgetary impulse of EUR200bn (1.5% GDP, incl. 30bn from EU), with the spending/tax mix left to member states. In addition some mobilisation of unused EU resources together with an additional 15 bn investments a year for two years by the European Investment Bank.

As welcome as this initiative is, it leaves open key questions about implementation. Europe has a classic collective action problem. There is a strong incentive on the part of each Member State (especially small ones) to free ride on the fiscal policy measures of the others. The European Council met on 11/12 December – as this contribution was going to press – and has agreed to support the Commission's package in principle, but

<sup>14</sup> Some samples. 'The shocks hitting the European economy are expected to (...) increase unemployment, thereby reducing demand. Structural reforms are therefore essential to sustain demand in the short-term (...)' (p. 5) and a discussion of fiscal policy focussing primarily on issues of longer-term sustainability (ibid.).

<sup>15</sup> However, there is a serious analytical (and resulting policy-recommendation) error regarding wage developments; see below.

with a reduced volume (around 1% of GDP). It remains to be seen to what extent this commitment is then transposed into actual changes on the spending and revenue sides of national budgets. Only such evidence will disperse doubts about Europe's ability to mount an effective *European* response.

Even allowing for the much more serious nature of the crisis in the US, the speed with which American policymakers have reacted and the sheer volume of the (monetary and fiscal) stimulus already provided or planned is a stark reminder that European economic governance institutions remain sorely inadequate.

## The design of a European economic recovery programme

### Are there constraints on expansionary policies?

A number of key elements of the analysis so far need to be borne in mind when designing a European programme to ensure that the continent emerges as quickly and painlessly as possible from the crisis. While a severe downturn lasting several quarters is a certainty, and some countries with serious imbalances to correct (UK, Ireland, Spain, some new Member States such as Hungary and the Baltic countries) will take some time to redress them, the decisive question is how deep and, in particular, how protracted the recession will be. There are some grounds for cautious optimism. The first is that unlike in 1929ff. (most) policymakers *know* what has to be done: stimulate aggregate demand to prevent cumulative recessionary/deflationary processes, prevent a downward wage/price spiral (and, internationally, a beg-

gar-thy-neighbour trade and exchange rate policies) and underpin the banking system with public money. We now know how to do these things, and, secondly, Europe is, as a whole, relatively unconstrained in implementing the required measures:

- With central bank interest rates at 2.5% (ECB) and 2% (Bank of England and Swedish Riksbank) there is still substantial scope for conventional expansionary monetary policy, in contrast to the US, where the Fed has already cut to 1%.
- Similarly, at the level of the euro area and the EU27, there is considerable room for manoeuvre for fiscal policy. The budget deficit in the current year is around -1.0% (EU27 1.2%)<sup>16</sup>. Within the euro area only France is close to the Maastricht ceiling of 3%; outside it Hungary and the UK have higher deficits. Moreover the structural primary balance (important for longer-term consolidation and proxy for the discretionary stance of budget policy) was calculated as being comfortably in surplus in the current year (1.9% and 1.4%), as it was also in both the previous years.
- The EU and euro area are large integrated economic areas with solid current account positions and, with some exceptions outside the euro area, a strong, international reserve currency. Thus there will be relatively few demand leakages from expansionary fiscal policies and there are no significant constraints on the external side; Europe does not have to worry about capital flight or foreign creditors demanding higher interest rates.

The situation – in the short-term – is a textbook case. We already have and we can expect a massive fall-off in consumption and investment demand. The level of demand must be sustained if there are not to be major job and output losses in the short term, with

<sup>16</sup> As assessed by the European Commission in July of this year (European Commission 2008c). Because of the crisis a slightly higher figure is now likely.



the severe risk of a negative feedback loop between the ‘financial’ and ‘real’ sectors – for example rising unemployment leading to increased defaults, worsening banks’ balance sheets causing further lending cutbacks, leading to more job losses. This would mean a protracted depression with longer-term effects (lower ‘potential’ growth). The private sector faces constraints and is deleveraging. The public authorities face few constraints in borrowing in their own currencies. (This is the key fault in the ‘analysis’ of the corner-shop economic commentators who say that if borrowing got us into the mess it cannot get us out of it.) And indeed, the public authorities will have *no choice* but to accept higher deficits: if the private sector decides to reduce its borrowing, public sector borrowing will have to increase, because in the current climate it will be very hard to expand net exports.<sup>17</sup> If fiscal loosening is done ‘voluntarily’, i.e. by way of expansionary fiscal policies, aggregate demand will stabilise at a level not too far below the current one. If the authorities resist this – as happened in the Great Depression – demand and output will contract sharply, ultimately bringing about the same government deficits, but at a much lower level of output.<sup>18</sup>

<sup>17</sup> This is because of the mathematical identity that net private sector saving plus net public sector saving (the opposite of the budget deficit) have to be equal to the current account.

<sup>18</sup> It may be useful in this context to recall the experiences of Sweden and the UK in the early 1990s, both of which were hit by severe shocks (in the case of Sweden also involving a banking crisis). In both cases the fiscal balance hit deficits of around 8% of GDP, only to recover strongly as the economy picked up and fiscal stimulus could be removed.

## A proposal for a European economic recovery programme

Against this background the following recovery plan would be appropriate to the economic situation in which the EU economy finds itself and to its specific institutional set-up. The package consists of five elements: expansionary monetary policy; a coordinated fiscal policy expansion; anti-deflationary wage policies; continued efforts to stabilise the financial sector; and *ad hoc* national measures to break negative feedback loops.

**First**, the ECB and other central banks should immediately announce their intention to bring about zero or negative real interest rates until it is clear that economic activity is picking up again. With inflation falling rapidly (the current figure being 2.1%), this implies an immediate further rate cut by the ECB of at least 0.5%; even better would be a full 1p.p. cut, bringing rates down to 1% (as in the US). At the same time, the Bank should announce that it is prepared to cut further, down to zero if necessary, and that if inflation dips below 0.5% it will immediately start quantitative easing operations (purchasing tradable securities with central bank money) in volumes sufficient to avert the risk of deflation. In the very short run this will stabilise economic actors’ expectations, reduce risks of deflation, ease pressures on the financial system, and reduce the risk of further currency appreciation; gradually it will stimulate aggregate demand.

**Secondly**, bearing in mind the lags that always attend monetary policy operations, and, in particular, the likelihood of the transmission channel through the banks being unusually sluggish at present, it is vital that fiscal policy acts swiftly and in coordinated fashion to inject spending directly into the economy. There are three main issues: the volume of the impulse; how to ensure that all Member States contribute in a balanced and

economically sensible way; and the appropriate mix of specific measures on the expenditure and revenue sides. Given the nature of EU policymaking, the latter point should be largely left to the Member States (see box). I put the need for discretionary fiscal stimulus in 2009 at 2% of GDP.<sup>19</sup> The really thorny issue is how this can best be brought about in the context of EU policymaking architecture. I propose the following steps:

1. The European Commission announces that it is suspending the excessive deficit procedure (EDP) under the Stability and Growth Pact for the duration of 2009, citing the 'exceptional circumstances' clause in the regulations. EDP monitoring will resume in 2010 provided economic growth is running at rates above 1%. Instead the Commission will monitor the implementation of Member States' fiscal recovery plans. This step is vital if fiscal action is to create positive rather than negative expectations concerning the medium-term.
2. Following a commitment by the European Council, each Member State must announce by the end of the year a package of fiscal measures that will inject or release spending of at least 1.5% of national GDP during the course of 2009. Attempts, monitored by the Commission, should be made to assess plausible *effective* impacts – rather than merely mechanical ones – of policy measures on spending.<sup>20</sup> This will tend to favour direct spending by government.
3. Countries with strong budgetary positions, facing relatively large negative shocks and/or with relatively small automatic stabilisers – Spain is an obvious example, but also Germany – should be encouraged to do more.
4. Member States should also be required to announce additional longer-term spending commitments in areas such as energy efficiency, research and development. Such measures will not have an immediate impact but will sustain demand into 2010 and beyond, contribute to medium-term expectations of recovery and are anyway desirable in terms of potential output, sustainability goals, etc.
5. At the European level the measures announced by the Commission in its Communication from end November (see above) should be implemented. A case in point is the European Globalisation Adjustment Fund which, in its first year, has completely failed to achieve its stated aim of assisting member states in cushioning workers from negative impacts of globalisation.<sup>21</sup> Unspent monies from this fund should be reallocated as quickly as possible to productive uses, for example boosting training programmes for workers in crisis-hit regions.
6. The Commission should report to the Council in June and at the end of the year

<sup>19</sup> The Commission called for 1.5%. The European Council has agreed on a package closer to 1%. My assessment is based on growth being around 3 p.p. below trend in 2009. Allowing an average 1% response by the automatic stabilisers in the short run leaves a stabilisation gap of 2% of GDP. The current proposal for 1% is not adequate given the current state of the economy, although it will certainly help – provided it is actually implemented.

<sup>20</sup> For instance cuts in VAT rates should make plausible estimates of the extent to which these will be passed on in prices; income tax cuts should take account of the different propensities to save of those affected (privileging tax cuts for less affluent households).

<sup>21</sup> This was a failure foretold; see Watt/Kemekliene 2006.

on the progress made in implementing the fiscal packages. Recalcitrant countries should face a procedure modelled on the excessive deficit procedure.

### **The design of national fiscal measures**

What sort of fiscal policy measures should Member States implement? For pragmatic political reasons the European authorities are right to remain agnostic about this. Proposals for common EU-wide policy steps (such as a cut in VAT rates, as recently proposed by the BRUEGEL institute (Pisani-Ferry *et al.* 2008) risk, in my view, generating opposition from single countries, which might scupper the whole idea of a coordinated stimulus. There is no intrinsic economic benefit in all countries injecting additional spending *in the same way*. If it were possible to reach agreement on a common approach, however, there may be some political (and indirectly possibly an economic benefit) in making visible a ‘European’ approach to resolving the crisis. The risks of such an approach appear much greater than the limited potential benefits, however.

Member States should tailor their packages to their specific economic and institutional conditions. The following general principles should be borne in mind.

- Increases in government spending will have a more immediate effect on demand than tax cuts.
- Measures targeted at those on average incomes and below are less likely to lead to higher savings and will thus have greater impact.<sup>22</sup>
- Demand-management measures should be such that they can be reversed once the economy recovers, although ‘structural’ measures, such as those that promote a low-carbon economy, should not.
- Wherever possible measures should be selected that also serve longer-term goals such as productivity and sustainability.
- Both equity and efficiency consideration argue in favour of targeting measures on those hardest hit by the crisis (implying, for example, a focus on labour market policy).
- While painful adjustment processes can and should be managed also using public funds, unsustainable structures (industries, asset prices) should not be artificially propped up.
- Public investment has shrunk as a share of GDP in most European countries and should be boosted (although this cannot be done overnight).
- Countries should adopt a *mix* of measures that combines desirable criteria (speed, effectiveness, equity, long-run benefit, etc.) and reflecting national priorities and any relevant institutional constraints.

<sup>22</sup> This is all the more important politically given the perception that massive public support for the financial sector has, in the first instance, benefited those on high incomes and capital owners.

**Thirdly**, Europe needs to erect a barrier against the possibility of deflation. It must avoid the mistakes made in the Great Depression, and also by Japan in the 1990s, of wages and prices chasing each other down. This can be done by putting a floor under nominal wages. In such a crisis downward nominal wage rigidity is a key anchor for the economy. Consistent ‘declaratory politics’ will be needed as a starting point: national governments, social partners and the European authorities must publicly emphasise the need for stable nominal wage growth and their rejection of beggar-thy-neighbour wage policies (cf. European Trade Union Confederation 2008).<sup>23</sup> In principle, wage growth should always hold to a medium-term orientation of the rate of productivity growth plus a price component (ideally the target inflation rate of the central bank). This implies normal wage growth (in the euro area) of around 3-3.5%. In the current context governments should announce that they are seeking that *all* wage agreements respect a minimum floor of 2%. Countries with a tradition of social pacts could incorporate provisions specifying such a minimum rate of nominal wage growth, while recommending a continued orientation towards medium-term productivity growth.<sup>24</sup> Governments must ensure that statutory minimum and public sector wages are kept on a stable growth path and should consider mak-

ing appropriate private-sector collective agreements binding. At the European level the ETUC and sectoral trade union federations should step up their monitoring of wage bargaining and exert pressure on member unions undermining the nominal wage floor.

After some 18 months of ‘bad news’ from financial institutions, there is reason to hope that the worst news from the financial sector is already out. This may not be the case, however. So, **fourthly**, national governments should continue to monitor the situation extremely carefully and take appropriate action to prevent systemically important financial institutions from going under (see also next section). As has more recently been the case with rescue packages, this should be done in such a way that costs to the taxpayer are minimised and the authorities take a share in any subsequent increase in the value of equity. In most cases this requires the partial or complete nationalisation of the entity and the imposition of losses on shareholders, and possibly also bondholders, and restrictions on certain operating practices.

Finally, **fifthly**, governments and, where appropriate, social partners should take *ad hoc* steps, depending on national circumstances, to break or mitigate negative cumulative causation chains and alleviate the social repercussions of the crisis. (To some extent, these measures can be financed and considered part of the fiscal policy package described above.) Examples of such measures include programmes that prevent house repossession by encouraging mortgage holders and homeowners to find repayment solutions that enable people to retain their homes<sup>25</sup>; similarly, banks, especially those in receipt of public support, must be induced or forced to continue lending to credit-worthy businesses and households; measures (at plant or sectoral level) that avoid redundancies through variations in working time,

<sup>23</sup> The Commission should urgently and publicly alter its wage policy recommendation in its recent communication.

<sup>24</sup> Social pacts should not, however, be used as beggar-thy-neighbour strategies. A coordination of such pacts at European level, for example under the auspices of the Macroeconomic Dialogue would be advantageous.

<sup>25</sup> If housing markets risk overshooting on the downside, more radical interventions to support prices may be necessary. However, this should not involve supporting bubble-inflated prices.



training programmes and other innovative measures; an expansion of active labour market policies; selective (and possibly temporary) improvements in the coverage of unemployment benefit and other welfare systems.

### **Policy response in the medium term: improving economic governance**

The focus of this paper has been on steps to ensure that the European economy avoids a prolonged recession. Yet both the onset of the crisis itself, and the inadequate reaction to it so far, point to the need for far-reaching reform of economic governance institutions within the European Union and the euro area; in some areas the crisis has exacerbated long-standing concerns, in others it has raised new issues of economic management and supervision. It is here that Europe should concentrate its 'structural reform' efforts in the coming months and years, to avoid future crises and improve the collective scope for addressing them. The most important areas for reform, along with some proposals, are briefly set out below.<sup>26</sup>

Clearly root-and-branch **re-regulation of the financial sector** is required. A large number of proposals have been made in this regard (e.g. Crotty/Epstein 2008; Stiglitz 2008). The key principle is that entities that (rightly) expect the authorities to provide support from public money in the event of failure must be clearly defined and must, in return, adhere to a set of rules that limits risk-taking, not least regarding the sorts of

financial instruments they can issue and purchase. Most consumers and pension/ insurance funds, etc. should be restricted to investing in the highly regulated sector. This is the most effective way to rein in the excesses of securitisation, leverage and short-term executive incentives that we have seen. High net worth individuals can be then left free to risk their own money in a more lightly (but not unregulated) 'casino' sector. Such re-regulation is vitally necessary in order to permit low real interest rates, which are key to stimulating investment and growth, without inducing private actors to take excessive risks and ramp up leverage to systemically dangerous levels.

What is essential from a European perspective is to avoid regulatory competition between jurisdictions and ensure that European-wide issues can be addressed at the appropriate level. This means either the establishment of a European public authority in charge of regulating financial services (**European Financial Services Authority**), or, second-best, strong coordination mechanisms between national regulators.

Linked to this, steps are required to **limit the procyclicality of the financial sector**. In this context some commentators have called for an end of mark-to-market methods of valuing book assets. Others have suggested that central banks should target, alongside consumer prices, also asset prices. This is a case where the cure may well be worse than the disease, however. The former recommendation risks permitting firms to mark-to-model, which can lead to cover up losses on their books, while the latter, had it been practised in Europe in recent years, would have meant substantially higher ECB rates: given the already long time Europe took to recover in the early years of this decade, one shudders to think how the European economy would have developed if rates had been, say one percentage point higher. What is vital is

<sup>26</sup> Clearly addressing the global imbalances described above also implies an agenda of reform of global institutions to address current account imbalances, exchange rate disequilibria, etc. For reasons of space this is not addressed here. See for example ITUC/TUAC/Global Unions (2008), and the contributions in Eichengreen and Baldwin (2008).

to break the link between the current value of book assets and financial institutions' minimum reserve/capital adequacy requirements. Instead these should vary contra-cyclically. The ECB itself has recognised this need<sup>27</sup> and various concrete proposals have been made (e.g. Palley 2008b). **Monetary policy requires multiple instruments** if it is to pursue multiple goals. Active use of minimum reserve requirements would enable central banks to lean against the wind of asset price developments, without at the same time leading to excessively high (or occasionally low) interest rates with respect to the state of the real economy and consumer inflation.

At the same time, ways need to be found to **increase the degree to which the central bank takes into account the real economy** in setting interest rates, in order to avoid major errors such as that by the ECB in the summer. In fact, the ECB does have a subsidiary mandate to support growth and jobs, but European policymakers remain silent when the ECB publicly repudiates this, saying it has 'only one needle in its compass'. This is an old debate (see contributions in Watt and Janssen 2006). Yet central bank independence, in the sense of freedom from day-to-day political interference, is compatible with the strengthening of the ties between the central bank and other actors (the euro group, but also the social partners in the Macroeconomic Dialogue). An advisory council to the ECB with representatives of social partners could be considered. I have previously argued (Watt 2005a) that it is a

waste of political energy to call for a change in the ECB's mandate, requiring as this would a Treaty change. If the crisis worsens, however, this may come back on to the agenda. In any case, the ECB has considerable leeway in interpreting its mandate, and could make more explicit a commitment to stabilising the real economy (e.g. by referring publicly to Taylor-type rules or to a target path for nominal GDP growth).

The **Stability and Growth Pact** has been substantially reformed since its Mark I version (Watt 2005b). Yet still it risks constraining necessary government activities. Public investment should not be subject to annual budgetary surveillance. More importantly, the Pact remains focussed on negative policy spillovers, and is thus inadequate to promote the positive fiscal policy spillovers that must be mobilised in times of crisis. In times such as these, it is important that countries are not able to free-ride on other countries' expansionary measures, and corresponding procedures should be introduced. Even after improvements, there is still too much focus on the extent of deficits and too little on the degree of counter-cyclicality. More generally, within the euro area the interaction between national fiscal policy and real exchange rates, (and thus relative competitiveness and current account imbalances within the EMU) is complex, and inadequately taken into account by the SGP (Allsopp and Watt 2003; Allsopp and Vines 2008)

More generally, our economies would be less subject to the vagaries of investor sentiment if a somewhat larger proportion of total spending on goods and services in the economy – this is not an issue about redistributive transfers – was in the public sphere. In concrete terms, this implies an **increase in public investment** to levels typical of advanced capitalist economies not so long ago (around 3% of GDP). This should be coupled with a

<sup>27</sup> See for example the recent speech by ECB President Trichet to the 18<sup>th</sup> Frankfurt European Banking Congress, <http://74.125.77.132/search?q=cache:uQR7uAH1k38J:www.ecb.int/press/key/date/2008/html/sp081121.en.html+trichet+ecb+speech+crisis+pro-cyclical&hl=en&ct=clnk&cd=1&gl=uk>

more strategic approach to industrial policy, in particular with a view to the required transition to a low-carbon economy, which will not come about through market signals alone (Larsson and Begg 2007, Degryse and Pochet 2009).

## **Conclusion and outlook**

In the teeth of a serious economic downturn, this analysis has been ‘conditionally optimistic’ about the medium-term prospects for the European economy. In the short term, there will be a significant contraction of activity. Some countries with imbalances to work off will remain with below-trend growth for an extended period. Substantial known unknowns (in particular risks in the massive credit default swap market, which is poorly understood) remain, along with, surely, some unknown unknowns. Financial crisis are unpredictable as their course is susceptible to herd behaviour and panics. However, indeed precisely because of this, there is no cause for fatalism. Some of the restrictive forces have already been lifted to varying extents (commodity prices, exchange rates, interest rates). Lower asset prices will create new opportunities, once sentiment can be turned around. More importantly, European and national policymakers have the knowledge, the tools and the policymaking ‘room for manoeuvre’ to turn the European economy around. The question is: will they use those tools?

The signs are mixed. Policymakers who have recently been happily singing from the hymn-sheet of liberal financial capitalism have in many cases been quick to adopt pragmatic non-market solutions. The Commission has also, if belatedly, dropped

some of its old thinking and has set forward a broadly sensible recovery package. Most recently the European Council has offered its – lukewarm – support. Similarly, the ECB has cut rates, although not far or fast enough.

However, the concerns about fiscal free-riding are intractable. The current debate on expansionary fiscal policy in Germany, the largest single economy, can only be described as bizarre. A large country, badly hit by cutbacks in domestic and foreign spending on investment goods, with a virtually balanced budget, a massive current account surplus, and a particularly serious negative (regressive) shift in income distribution (OECD 2008) and years of depressed domestic demand and under-investment in public infrastructure has been discussing stimulus packages that are absolutely derisory (and also badly targeted). German media is dominated by so-called experts who queue up to denounce higher spending as being merely a ‘straw fire’ and worry about the debt burden on future generations.<sup>28</sup> The German finance minister has lectured the UK on its supposedly irresponsible bailout and stimulation policies – and in return been castigated by the current Nobel laureate, Paul Krugman. A disaster for Germany, such policy advice is a serious blow for Europe, both because of the weight of Germany in the European economy, and the disincentive effects that such a stance, if maintained, will have. It is vital that Germany substantially loosens its belt in the current crisis. The government’s current reluctance to countenance this is one of the key reasons for remaining pessimistic about the short-term future of the European economy.

A second main risk is that the ECB will continue to remain behind the curve. If it waits too long and prices start to fall, then (conventional) monetary policy will have lost its effectiveness and the situation could become very serious indeed.

<sup>28</sup> Virtually a lone dissenter has been the Institut für Makroökonomie und Konjunkturforschung, see various articles and statements under <http://www.boeckler.de/31923.html>.



There are some unknowns in the equation, notably the possibility that nasty surprises, hidden to date, remain in some area of the financial system. However, even these could probably be coped with using the sort of measures recommended here, although the dosage would have to be increased in such a case. This emphasises the need to move quickly. The credit default market is clearly sensitive to the number of bankruptcies. Policymakers must on no account use the threat of such markets imploding as an argument to ‘save their ammunition’. On the contrary, the contractions in the ‘real’ and ‘financial’ sectors are inextricably linked. Aggregate demand and real output must be stabilised *now*.

The central finding of this analysis can be stated starkly. Europe need not experience a repeat of 1929 (or even the early 1990s).

Given its fundamentals and the policy tools at its disposal, the downturn, although painful and costly, need only be relatively short and not too deep. We are not condemned to repeat every historical tragedy. The risks of inaction are great, however. The crisis will not resolve itself. A number of financial-market time-bombs are in all probability ticking. It is only swift and resolute – but not particularly complex or institutionally demanding – policy action that will prevent the situation deteriorating into a lost decade, as in Japan, or in the worst case, a major meltdown on the lines of the Great Depression.

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